by JOHN A. GORMAN

Recent Financial Developments

THE financing of the expanded level of investment in the third quarter began to show some of the earmarks of the financial pattern of earlier postwar business upswings. Business fixed investment outlays rose at a somewhat faster pace than internal funds during the quarter; the rise in bank reserves and credit expansion slowed; and interest rates tended to rise. This was in contrast to developments during the period from the recession low in early 1961 through mid-1963, when internal funds rose faster than business investments; bank reserves were maintained at a volume which permitted a peacetime record expansion in bank credit; and long-term interest rates tended to fall, while short-term rates moved up moderately.

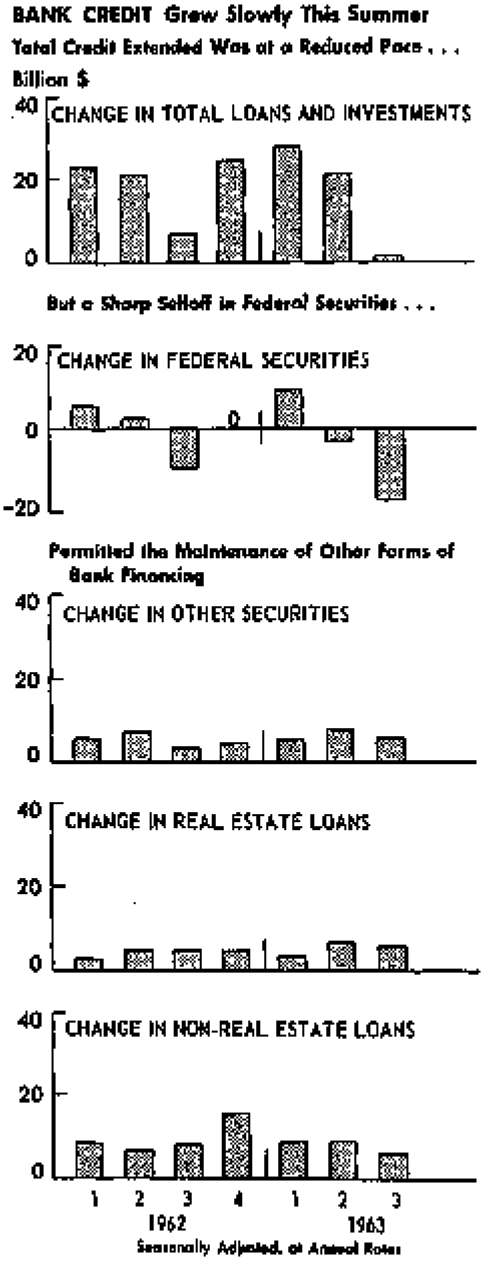
Outlays for residential construction and consumer durables have been running counter to the experience of earlier postwar expansions. These outlays and the associated borrowing have tended to rise irregularly throughout the current recovery in contrast to previous economic advances when declines in these sectors developed fairly early. During the third quarter, residential construction moved up, and auto and other durable goods buying remained comparatively strong.

Monetary policy less easy

The Federal Reserve System exerted some restraint on member bank reserve positions during the summer in the face of the balance of payments deficit. The first half rise in the balance of payments deficit was associated with capital movements, and the monetary measures were designed to inhibit them. Credit remained readily available for domestic borrowers throughout the period.

The shift toward somewhat less easy credit conditions was signaled by an increase in the discount rate from 3 to 3½ percent in July and further effected by a slowing in the pace of open market purchases. During the past three months, net purchases of Treasury securities by the Federal Reserve System—which add to bank reserves—were less than the reductions in commercial bank reserves stemming from currency and gold outflows. Total reserves, however, were maintained, as banks stepped up their borrowing to $313 million in October as compared with $76 million in the comparable period of last year.

BANK CREDIT Grew Slowly This Summer



The recent changes in monetary policy followed an unusually long time of relatively easy credit conditions for a period of economic advance. During the economic advances following the 1954 and 1958 recessions, the monetary authorities had moved towards substantially tighter credit within a year after the upturn. During the current advance—which started early in 1961—the monetary authorities maintained generally easy reserve positions: whereas borrowings had exceeded free reserves within a year after the earlier upturns, they have not yet done so in this one. Interest rates have also shown a generally easy tone as compared with the rapid advances characteristic of prior cycles.

Bank expansion slows

Commercial bank credit expansion slowed during the summer. Total bank credit rose only $¾ billion (seasonally adjusted) as compared with $5½ billion in the spring quarter, and a peacetime record of $7 billion during the first quarter of 1963. The slowdown in commercial bank credit expansion featured a $4¼ billion reduction in Federal Government securities—following a modest sale of $¾ billion in the second quarter and net purchases aggregating $2½ billion in the first. (See chart.)

All categories of bank credit other than Federal securities continued to rise during the summer quarter, though generally at a somewhat slower pace than in the second. Purchases of tax-exempt securities were off from the second quarter level but continued well above those of earlier quarters. Commercial banks continued to invest substantial sums in real estate mortgages, although here, too, the pace slowed moderately from the spring quarter. Business borrowings and consumer credit extensions remained high, though these were also off from the spring quarter rate. Security credit was the only category showing a stepped-up rate of expansion during the third quarter.

A continuing rise in the relative proportion of time deposits tended to cushion the effects of the changes in the banks' reserve positions noted earlier since time deposits carry a reserve requirement between one-fourth and one-third of that on demand deposits. Time deposits rose by $3 billion. Demand deposits showed little change in the aggregate: a $1 billion rise in private demand deposits just matched a more than seasonal reduction in Federal Government demand deposits.

Since time deposits are in fact readily convertible into cash, and average interest rates paid on such deposits by banks have been rising, corporations and individuals have kept larger shares of their liquid reserves in this interest-earning medium. The summer expansion in time deposits was in line with developments over the past decade when time deposits rose $64 billions, demand deposits rose only $19 billions.

Other financial institutions

The aggregate volume of lending by savings institutions other than banks continued during the summer at the high rate reached earlier this year. The buoyancy in aggregate lending masked divergent movements among institutions: Savings and loan associations and insurance carriers stepped up their mortgage lending; mutual savings banks reduced theirs.

Savings and loan associations continued to expand their mortgage lending activities although new share holdings dipped from the second quarter pace after dividend rates were reduced in July. The deficiency in savings inflow was made up by borrowings from and reductions in deposits with the Federal Home Loan Banks. Despite the weakness in savings inflow, mortgage loan commitments were at an alltime high.

The flow of savings to mutual savings banks slowed from the $3¾ billion pace ruling since early last year. Mortgage lending by these institutions also slowed moderately.

The net inflow to life insurance companies continued at the $1½ billion rate first reached in 1962. These funds were used in adding to mortgage portfolios and in purchasing corporate and foreign securities. Federal security portfolios showed little change in contrast to a net liquidation during the spring.

Financing costs

The developments within the financial sector just reviewed, in combination with a relatively firm demand for credit, were reflected in financing costs during the third quarter: short-term yields rose at the sharpest pace in a year and a half; long-term market yields drifted upwards; and the two-year decline in mortgage interest rates halted. The rise in short-term yields was particularly pronounced for 3-month Treasury bills, yields on which spurted at midyear and have continued to rise irregularly since. The rise also extended to intermediate-term issues: Treasury issues maturing in 3 to 5 years carried rates averaging 3.9 percent at the end of the quarter, as compared with 3.7 percent at the beginning.

The rise in long-term yields was most noticeable for instruments actively traded in the market: yields on taxable Treasury bonds rose 0.04 percentage points during the quarter; high-grade municipal bonds were up 0.04 percentage points; while corporate bonds rated Aaa increased by 0.08 percentage points. Interest costs showed no change for either FHA or conventional mortgage loans during the quarter, ending a decline which had persisted for nearly two years.

The net result of the differential movements in interest rates during the summer was to reduce further the spread between short- and long-term

Table 1.—Sources and Uses of Corporate Funds, Annual, 1959–62; Half Years, 1959–63 [1] [2]

[Billions of dollars]

	Year				First half					Second half			
	1959	1960	1961	1962	1959	1960	1961	1962	1963	1959	1960	1961	1962
Sources, total	57.1	46.3	49.7	57.8	28.0	23.3	18.9	26.4	29.5	29.2	22.9	30.8	31.4
Internal sources, total	31.1	29.1	30.6	34.8	15.1	15.1	14.2	17.2	18.8	16.1	14.0	16.4	17.6
Retained profits [3]	9.5	6.2	6.6	7.0	5.4	3.8	2.4	3.6	4.3	4.1	2.4	3.8	3.4
Depreciation	21.6	22.9	24.0	27.8	10.6	11.3	11.8	13.7	14.5	11.0	11.6	12.2	14.1
External long-term sources, total	9.5	9.8	11.2	10.2	4.5	4.6	6.2	5.4	6.0	5.1	5.2	5.0	4.8
Stocks	3.7	3.0	4.5	2.1	2.1	1.6	2.8	1.4	.5	1.6	1.4	1.7	.6
Bonds	4.1	5.0	5.1	5.0	1.8	2.0	2.7	2.7	2.5	2.3	3.1	2.4	2.3
Other debt	1.6	1.7	1.5	3.1	.6	1.0	.7	1.2	2.0	1.1	.8	1.0	1.9
Short-term sources, total	10.6	7.4	8.6	12.5	7.4	3.6	−1.6	3.6	6.7	3.1	3.7	10.2	9.0
Bank loans	3.4	1.3	.4	3.0	2.5	1.3	−.4	.6	(4)	.9	(4)	.7	2.4
Trade payables	5.3	4.5	6.1	5.5	1.7	2.2	.1	1.9	4.6	3.6	2.3	6.1	4.2
Federal income tax liabilities	2.1	−1.6	.8	.9	.4	−2.4	−2.1	−.5	−.8	1.7	.8	2.7	1.4
Other	3.7	3.2	1.6	3.2	2.8	2.5	.9	2.2	2.0	.9	.7	.8	1.0
Uses, total	52.1	43.9	48.4	53.6	26.0	21.7	19.1	25.0	26.4	26.1	22.1	29.3	28.6
Increase in physical assets, total	34.2	33.3	31.4	35.8	17.7	18.7	14.5	18.0	18.9	16.5	14.6	16.9	16.9
Plant and equipment	27.7	30.8	29.6	32.0	12.8	14.6	13.9	15.1	15.4	14.9	16.1	15.7	16.9
Inventories (book value)	6.6	2.5	1.8	3.8	4.0	4.1	.6	2.8	3.4	1.8	−1.6	1.2	(4)
Increase in financial assets, total	17.9	10.5	17.1	17.8	8.3	2.9	4.7	6.1	7.5	9.6	7.6	12.4	11.7
Receivables	10.9	8.6	9.6	11.3	5.5	4.1	2.7	5.4	6.2	5.3	4.5	7.0	5.9
Consumer	2.4	1.8	.1	2.8	−.1	.1	−2.0	−.3	−.7	2.5	1.7	2.1	3.0
Other	8.4	6.9	9.6	8.6	5.6	4.1	4.6	5.6	6.9	2.8	2.8	4.9	2.4
Cash and U.S. Government securities	2.9	−1.7	2.5	1.2	.1	−3.6	−1.0	−3.1	−2.9	2.9	1.9	3.6	4.3
Cash (including deposits)	−1.1	1.0	3.0	.7	−1.9	−2.0	−.8	−3.1	−3.0	.8	3.0	3.9	3.8
U.S. Government securities	4.0	−2.6	−.5	.4	2.0	−1.6	−.2	−.1	.1	2.0	−1.0	−.3	.5
Other assets	4.1	5.5	4.0	5.3	2.7	2.4	3.0	3.0	4.2	1.4	1.1	1.6	1.5
Discrepancy (uses less sources)	−5.0	−2.4	−1.3	−4.1	−2.9	−1.6	.2	−1.3	−3.1	−3.1	−.8	−1.5	−2.8

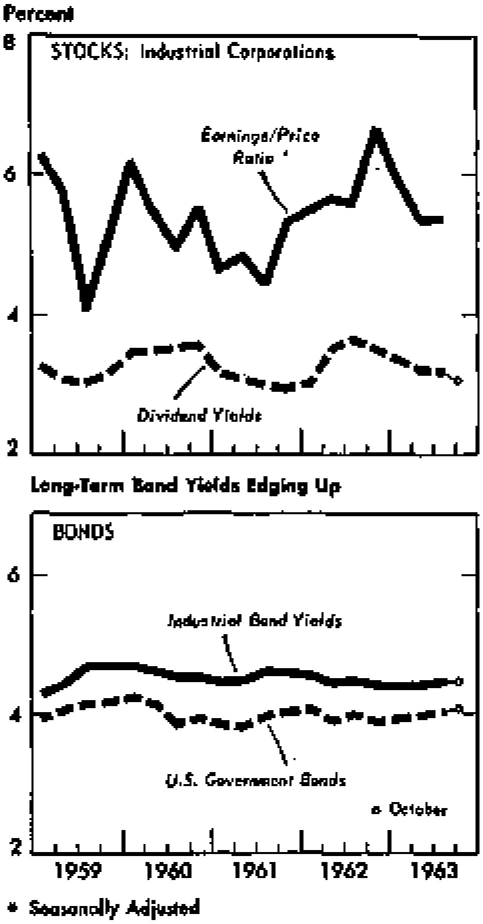
1. Data for 1946–55 may be found in Table V-10 of *U.S. Income and Output*. 1956–58 estimates are in table 21 of July 1962 SURVEY.
2. Excludes banks and insurance companies.
3. Includes depletion.
4. Less than $50 million.

Sources: U.S. Department of Commerce, Office of Business Economics, based on Securities and Exchange Commission, and other financial data.

interest rates. In the case of Treasury securities, 3-month bill yields were only ⅜ percentage point below long-term bonds, as compared with a differential of over one percentage point in June. Such a narrowing in yield spreads has been a characteristic feature of every period of rising interest rates: during the money-market stringency of late 1959 and early 1960, yields on 3-month bills actually climbed above those on long-term bonds.

FINANCING COSTS

Stock Financing Costs Down



* Seasonally Adjusted

U.S. Department of Commerce, Office of Business Economics 63-11-11

After some hesitancy in the spring, common stock prices resumed their upward movement and by September most indexes had passed the previous peaks of late 1961. The increase in stock prices was paralleled by a marked rise in stock market credit, as had been the case in each of the major postwar advances in stock values. Indicators of the small investor's interest—net purchases through odd lot dealers and net mutual fund purchases—continued to reflect caution despite the price rise. During earlier periods, these transactions had moved up as the price advance lengthened. In October, the Federal Reserve raised margin requirements on stock purchases from 50 to 70 percent.

With rising stock prices, earnings-price ratios and dividend yields have fallen: the decline in these ratios was limited by a sharp expansion in profits and dividends, so that stock financing costs are still at moderately high levels.

Corporate Finance

Corporate investment in plant and equipment rose for the second successive quarter. Apartment-house construction also moved up and inventory and other working capital requirements continued at high levels. Internal funds also increased, but, in contrast to the pattern up to the recent period, the rise was not so great as that in investment. With external financing unchanged from the second quarter, there was apparently some reduction in liquid asset holdings.

Corporate investment up

The third quarter rise—$2 billion—carried corporate plant and equipment investment to a total of $34¼ billion (annual rate). All industry groups shared in the latest advance except "other transportation." Particularly noteworthy was the rise in manufacturing, which brought this group close to the previous peak of mid-1957. Investment by public utilities and "commercial and other" firms, also registered substantial gains. Railroad outlays rose 20 percent, and reached a rate equal to that of 1956. In addition to the advances in plant and equipment spending, the construction and purchase of apartment houses—included in "other assets" in table 1—also continued strong.

The rise in economic activity during the summer was accompanied by higher working capital requirements. Although inventory buying was little changed, incomplete data indicate an increase in customer financing—including consumer credit and trade receivables—as the volume of transactions rose.

Corporate financing

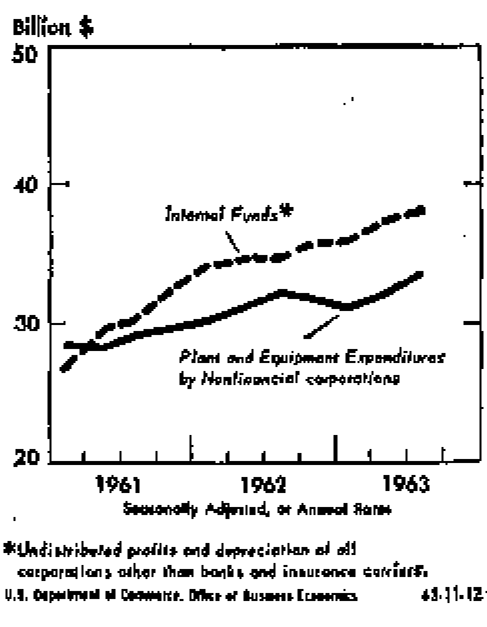
Internal funds of nonfinancial corporations rose about $1 billion (annual rate) in the third quarter. Advances in retained earnings and in depreciation charges contributed about one-half billion dollars each to the expansion. Though the latest increase was substantially below that in plant and equipment outlays, the flow of internal funds continued well above the level of capital spending; a two-fifths rise in internal funds over the past 2½ years has considerably outstripped an increase of one-fifth in capital outlays.

As noted above, the total of external financing (including short-term bank loans) was about the same in the third quarter as in the second. There were some shifts in composition: Net funds raised through bond and stock issues were unchanged from the low second quarter level, but short-term bank borrowing fell moderately, and mortgage financing rose.

Although net bond issues were unchanged, the gross flotation of new bonds was off; the volume of refinancing, high during the spring, also fell as interest rates firmed. Yields on Aaa rated corporate bonds moved up during the summer, after having gradually declined during the previous 2 years.

Stock issues showed little change. The volume of new issues has remained at a low level throughout the current rise in stock prices; stock financing

CORPORATE INVESTMENT AND CASH FLOW



*Undistributed profits and depreciation of all corporations other than banks and insurance carriers.

U.S. Department of Commerce, Office of Business Economics 63-11-12 costs have shown only a modest improvement relative to bond yields, and investor interest in new issues has remained weak. Investment company issues also showed little expansion despite the rapid rise in stock prices; in earlier market advances purchases of these securities had tended to move up.

The rise in mortgage borrowing during the summer reflected increases in construction loans and the financing of expanded apartment house, office and commercial building.

There was a modest third-quarter reduction in bank borrowing. Finance companies increased their borrowing, while other corporations reduced theirs. Towards the end of the quarter, there were some indications of a strengthening in bank loan demand: Finance company requirements moved up after the introduction of new model automobiles and borrowing by other corporations was reported strong in the closing weeks of September.

Liquid assets off

Corporations apparently reduced their aggregate holdings of liquid assets—deposits and U.S. Government securities—during the summer. In addition, there was a continuation of the shift from demand deposits and U.S. Government securities to time certificates of deposits—particularly in July when interest rates payable on short-dated issues were raised.

Comparison with previous advances

During the advance from the early 1961 cyclical low through June of this year, the greater abundance of internal funds relative to plant and equipment outlays had marked effects on corporate financing practices. As compared with previous periods of economic expansion, corporations depended little on stock or bond flotations or on commercial bank loans. Further, they have increased moderately their liquid asset holdings over the first 2 years of the current business rise. During previous business upswings, the relative scarcity of internal funds had been reflected in marked rises in external financing and a draft on liquid assets accumulated in the previous recessions. Thus corporations put less demand on, and supplied more funds to, the money and capital markets during the first 2 years of the current business expansion than during earlier periods of economic advance.

While the available data suggest that financial developments during the third quarter apparently marked a partial return to the pattern of earlier advances, it should be noted that most corporations are still in a highly liquid position for this phase of the cycle.

Consumer Finances

Purchases of houses and consumer durables remained high during the summer as did the use of mortgage and installment credit. During the same period, personal saving totaled $30 billion—about the same as in the second quarter. Debt repayments moved up and investments in liquid claims fell off.

As indicated in the chart, residential construction and consumer durable purchases have moved irregularly upward over the past two and a half years. A willingness by individuals to borrow increased sums relative to income played an important role in facilitating these transactions. In this respect, the third quarter showed little change.

Mortgage borrowing

Nonfarm residential mortgage recordings reached an alltime high of $38½ billion at seasonally adjusted annual rates during the summer. This was $1 billion above the second quarter pace and represented a 20 percent advance over the past 2 years.

The residential mortgage market has presented a quite different picture during the current business advance than in earlier ones, when mortgage borrowing and residential construction declined as banks withdrew from the mortgage market during periods of tight money. In contrast, the banking system has this time been a substantial net supplier of mortgage credit. With credit readily available, and interest costs declining up to midyear, there appears to have been an increasing use of borrowed money in the turnover of existing properties, as well as in financing non-housing outlays such as college educations.

During the third quarter, the mortgage market was supported by the banks' portfolio adjustments referred to earlier. Nevertheless, banks reduced their mortgage lending moderately but this was more than offset by a rise in lending by savings and loan associations and insurance companies.

Consumer credit

Consumer purchases of autos and other durables showed little change during the third quarter from the high rate of earlier quarters. The call for consumer installment credit was about the same in the summer as it had been in the

Table 2.—Sources and Uses of Corporate Funds by Industry, Years Ended June 30, 1960–63 [1]

[Billions of dollars]

	Manufacturing and mining				Railroads				Transportation other than rail				Public utilities and communications			
	1960	1961	1962	1963	1960	1961	1962	1963	1960	1961	1962	1963	1960	1961	1962	1963
Sources, total	21.8	18.4	26.6	27.9	.6	.3	.6	1.0	2.3	1.6	1.7	1.9	8.6	8.9	8.7	8.4
Retained profits [2]	8.7	4.5	6.1	6.4	−.2	−.2	−.3	−.2	−.1	−.1	−.1	−.1	.6	.6	.8	.9
Depreciation	10.9	11.3	12.8	14.7	.9	.9	1.0	1.1	1.4	1.4	1.5	1.6	3.5	3.7	4.0	4.2
External long-term sources [3]	1.3	2.4	1.7	2.5	−.1	−.2	−.2	(4)	.4	.4	.1	.2	3.5	4.3	3.4	2.5
Short-term sources [5]	2.9	.2	5.9	4.3	.1	(4)	.1	.1	.6	−.1	.2	.3	1.1	.3	.5	1.0
Uses, total	18.3	16.1	23.8	24.6	1.0	.6	.9	1.1	2.2	2.0	1.9	1.8	9.0	10.3	9.3	9.8
Plant and equipment	14.3	14.9	14.8	16.0	1.0	.9	.7	.9	1.0	1.0	1.8	1.7	8.5	8.7	8.9	9.1
Inventories (book value)	3.4	−1.2	3.3	2.2	.1	(4)	(4)	(4)	(4)	(4)	(4)	(4)	.1	(4)	(4)	−.1
Receivables and misc. assets	2.7	3.3	5.2	6.0	(4)	(4)	(4)	(4)	.3	.3	.2	.2	.4	.7	.5	.7
Cash and U.S. Government securities	−2.1	−.9	.5	.0	−.1	−.3	.2	.2	(4)	.1	−.1	(4)	(4)	.8	−.1	.1
Discrepancy (uses less sources)	−3.5	−2.4	−2.8	−3.3	.3	.3	.3	.1	−.1	.4	.2	(4)	.4	1.3	.6	1.4

1. Data for the year ended June 30, 1957 may be found on p. 17 of the October 1960 Survey; for the year ended June 30, 1958 on p. 22 of the November 1961 *Survey* and for the year ended June 30, 1959 on p. 4 of the November 1962 *Survey*. Statistics for the year ended December 31, 1958 are on p. 18 of the May 1962 *Survey*, and for years ended December 31, 1959–62 on p. 12 of the May 1963 *Survey*.
2. Includes depletion.
3. Includes stocks, bonded debt, long-term bank loans, mortgages and other long-term debt.
4. Less than $50 million.
5. Includes short-term bank loans, trade payables, Federal income tax liabilities, and miscellaneous liabilities.

Source: U.S. Department of Commerce, Office of Business Economics, based on Securities and Exchange Commission, and other financial data.

spring, and a record volume of $15 billion in loans was extended during the quarter.

The enhanced willingness of consumers to borrow—which has been a characteristic of the entire postwar period—has been reflected in an uptrend in the ratio of consumer credit extensions to disposable personal income. By the end of the summer, this ratio was approximating 15 percent as compared with 14¼ percent a year ago.

Personal investment

While cutting back on their saving through commercial bank deposits, individuals continued to add to their holdings of savings and loan association shares at the record volumes recorded in the past several quarters. The volume of debt repayments moved up during the summer, reflecting the heavy volume of consumer and mortgage debt incurred in the recent past.

Fragmentary data indicate that individuals continued to sell common stocks on balance during the summer. This was particularly noteworthy because the summer was marked by a renewed upsurge in common stock prices. During previous advances, there had normally been upward turns in net trading through odd-lot dealers and purchases of mutual fund securities. During the most recent advance in stock prices, these indicators showed little increase in personal participation.

Government Finance

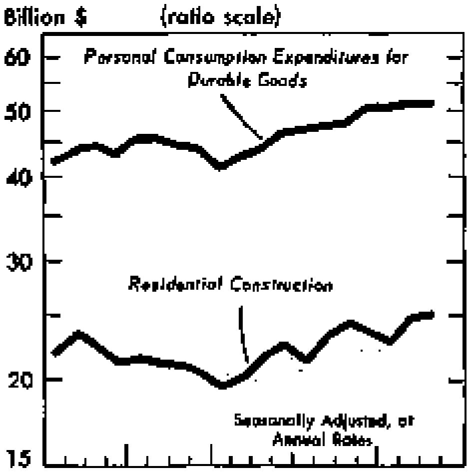
Overall financing requirements of Federal, State, and local governments were little changed during the summer from the levels of the preceding quarter. An improvement in the seasonally adjusted national income accounts deficit for the Federal Government was offset by a speedup in check processing. State and local bond flotations continued at the $2 billion pace of the past six quarters.

Federal finance

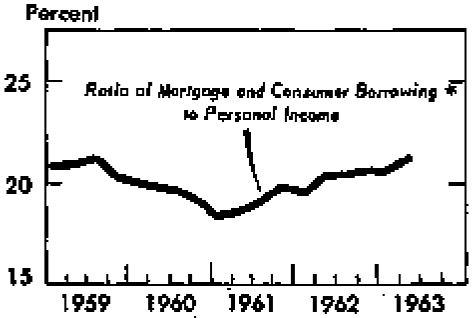
The Federal deficit on income and product accounts amounted to about $2 billion in the third quarter, a reduction of one-third from the spring rate, and the smallest since the cyclical low early in 1961. The third quarter improvement reflected a stabilization in expenditures, which rose only $¾ billion to $116 billion, and continued advances in tax accruals, which rose nearly $2 billion to an annual rate of $114 billion.

In spite of these changes, cash requirements moved up as there was a rise in the volume of checks paid as compared with checks issued. The government reduced its average cash holdings during the quarter by enough to meet the additional requirements and the volume of borrowing from the public was reduced on a seasonally adjusted basis.

Consumer Durables and Residential Construction Have Been Maintained At High Rates . . .



and Have Been Accompanied by a Rise in Borrowing Relative to Income



* Gross of repayments Data: FRB & OBE

U.S. Department of Commerce, Office of Business Economics 63-11-13

Federal debt operations during this period resulted in a rise in securities due in five years or more, and a reduction in short-term issues. The decline in short-term securities stemmed from an advance refunding operation in September when approximately $4 billion of securities due within a year were exchanged for longer term issues. The outstanding volume of Treasury bills rose $1 billion during the quarter. Advance refunding techniques have been used to stretch the maturity structure of the Federal debt as such techniques tend to achieve the desired lengthening of the debt structure without undue upward pressure on long-term rates.

State and local borrowing

Borrowing by State and municipal governments continued at a high pace. The high and rising level of public construction together with generally easy money conditions has helped sustain an average pace of $9 billion in such financing over the past 2 years. As interest costs generally tightened during the summer, there was a tendency for municipal bond yields to move irregularly upwards.

Foreign borrowing

Reduced private capital outflows played a major role in a sharp improvement in the balance of payments during the third quarter. The volume of foreign securities issued in the United States fell from about $520 million in the second quarter to about $175 million in the summer, and short-term bank credits were reduced from an outflow of close to $400 million in the spring to a net inflow of nearly $100 million in the third quarter. This marked a reversal of developments in the first half of 1963, when there had been a marked step-up in the pace of foreign security flotations in the United States market and a shift in short-term bank lending from an inflow of $78 million in the first quarter to an outflow of $400 million in the second.